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February 3, 1992 Four Dollars

Forbes

Dow Jones CEO
Peter Kann

Can he preserve the franchise?

Forbes
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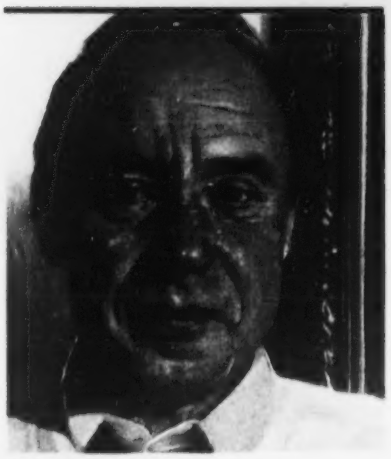

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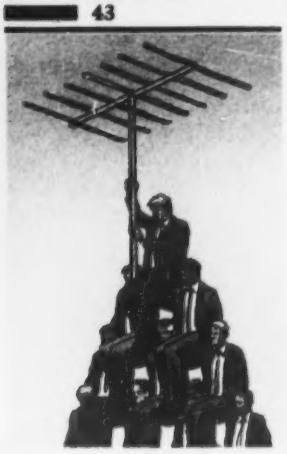

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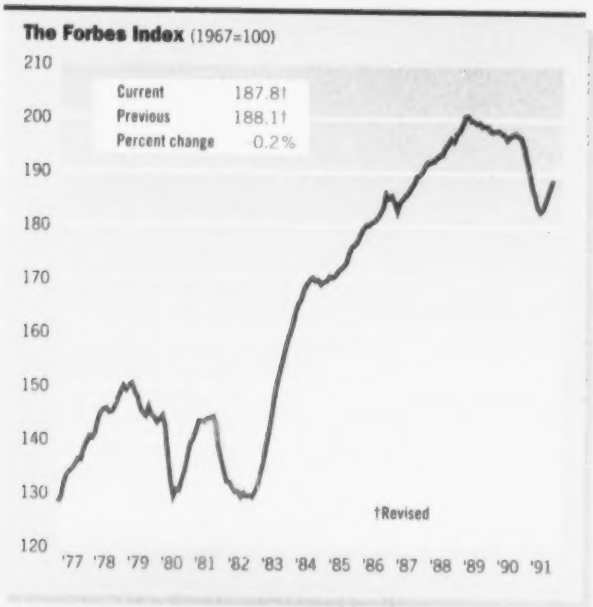
BY TIMOTHY DODMAN



The recession has eliminated nearly 1.6 million jobs since it began in July 1990; roughly half the losses took place in 1991. A glimmer of hope may be found in December's job report: Seasonally adjusted nonfarm payrolls increased by 31,000 workers. Though too small to indicate any real momentum, this gain is a move in the right direction. Meanwhile, wholesale prices of finished goods declined 0.1% in 1991, the first annual decline since 1986. Investors may be getting paltry yields on their investments, but they are losing a smaller bite to inflation.

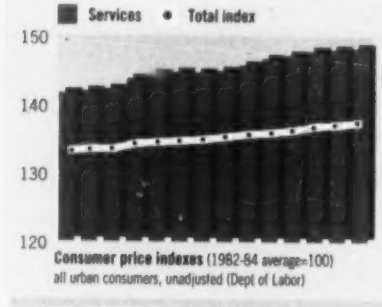
Other key rates	Source	Status
Prime rate	Chase Manhattan Bank	6.5%
Auto sales 1991 vs 1990[1]	Ward's Automotive	-11.0%
Index of leading indicators Nov vs Oct	Dept of Commerce	-0.3%
Trade balance 12 months ended Oct 1991	Dept of Commerce	-$71 bil
All-commodity producer price index Dec vs Nov[2]	Dept of Labor	-0.4%
GDP 3rd quarter vs 2nd—annualized growth	Dept of Commerce	1.8%
M2 (3-month change)—annualized growth[3]	Federal Reserve	2.0%

[1] U.S.-based manufacturers, excludes imports, as of 12/31/91. [2] Wholesale goods. [3] Includes M1 (public currency and checking deposits) plus savings accounts and money market funds.

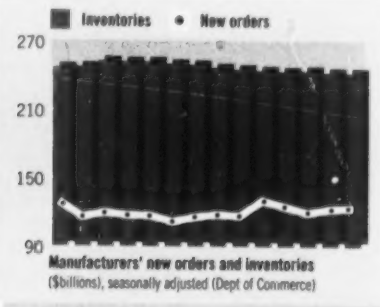
Index components

The Forbes Index is a measure of U.S. economic activity composed of 8 equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, new housing starts, total retail sales, the level of new orders for durable goods compared with manufacturers' inventories, personal income, total consumer installment credit.

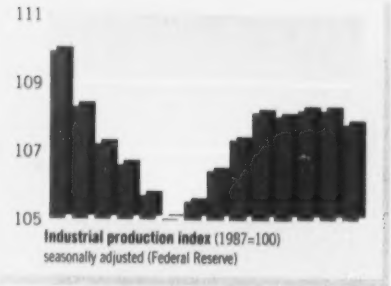
To measure these 8 elements, FORBES monitors 10 series of U.S. government data. The last 14 months' data for each series are presented below.



Consumer price indexes (1982-84 average=100) all urban consumers, unadjusted (Dept of Labor)

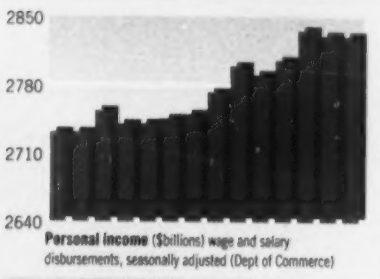


Manufacturers' new orders and inventories ($billions), seasonally adjusted (Dept of Commerce)

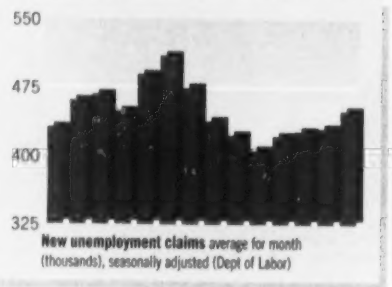


Industrial production index (1987=100) seasonally adjusted (Federal Reserve)

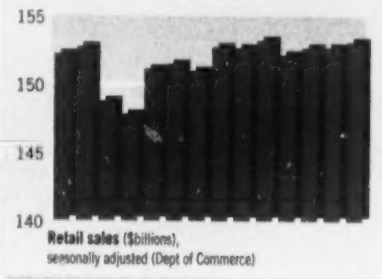
New housing starts (thousands) privately owned, unadjusted (Dept of Commerce)



Personal income ($billions) wage and salary disbursements, seasonally adjusted (Dept of Commerce)



New unemployment claims average for month (thousands), seasonally adjusted (Dept of Labor)



Retail sales ($billions), seasonally adjusted (Dept of Commerce)

Consumer installment credit ($billions) total, seasonally adjusted (Federal Reserve)

O N D J F M A M J J A S O N O N D J F M A M J J A S O N O N D J F M A M J J A S O N

As businesses slim down, they sometimes spin off subsidiaries rather than sell them. Such spinoffs present opportunities for investors.

Healthy babies

By Eric S. Hardy

BACK IN 1984 Time Warner—Time Inc., as it was then—distributed to its shareholders stock in Temple-Inland, a timber company in Texas. Since the day after the spinoff, Time Warner stock has climbed only 112%, but Temple-Inland shares have almost quadrupled.

The Temple-Inland phenomenon is not very unusual. A diversified company aims to sharpen its focus or dump an unattractive sideline. Rather than sell the business, which might take a while or cost it corporate capital gain taxes, the parent just gives the business away to its own shareholders.

These spinoffs often present buying opportunities for astute investors. Enough of those shareholders may dump the spun-off company to depress the latter's share price for a brief period. Then the spinoffs bounce back in price.

Penn State finance faculty members James Miles, Patrick Cusatis and Randall Woolridge, in a research paper presented in Chicago last year, found that spinoffs outperform the market. "We studied 146 companies formed by spinoffs since the 1960s and concluded that, during their first three years, they outperform the S&P by 35%," says Miles.

Here's another success story. Kaydon, a Florida-based bearing manufacturer, was distributed in April 1984 to holders of a smallish electronics firm called Bairnco. Since then Bairnco stock has lost more than one-third its value. But Kaydon turned into a big winner. Its shares are up more than 700% since the 1984 spinoff transaction.

According to *Spinoff Report*, a monthly newsletter published in New York, 73 companies went public between 1984 and 1989 via spinoffs.

In the future, spinoffs may become less common. One of their attractions is the benefits they bring to the parent company. But these may end soon because of changes in tax law (FORBES, *Sept. 2, 1991*).

The table below shows ten announced but as yet unconsummated spinoffs. Several of these subsidiaries are clearly being booted out of the corporate nest because they drag down the parent's image or profits. Thus Dial (formerly Greyhound) is unloading its commercial lending outfit, and General Dynamics is detaching, with all the attendant product liability problems, Cessna Aircraft, a manufacturer of business aircraft. When they start trading separately, these spinoffs could present buying opportunities. But be careful: Don't overpay. Remember that other investors are not ignorant of the Kaydon phenomenon.

Look at each situation separately. You can't buy blindly and expect to get the excess returns that Professor Miles tabulated. ■

Kicking the little ones out of the nest

Parent/business	Recent price	Sales ($mil)[1]	Spinoff/business	Sales ($mil)[1]	Operating income ($mil)[2]	Proposed spinoff date
Burlington Resources/oil & gas	34¼	1,900	**El Paso Natural Gas**/natural gas	645	148	early 1992
Dial/consumer products	48½	3,519	**GFC Financial**/commercial lending	278	44	early 1992
First Mississippi/chemicals	11⅞	537	**FirstMiss Gold**/gold mining	74	3	undecided
General Dynamics/aerospace & defense	56½	10,173	**Cessna Aircraft**/business aircraft	716	106	undecided
Greyhound Lines Canada/bus transportation	28⅝	265	**Motor Coach Industries**/bus manufacturing	120	NA	mid-1992
Hathaway/precision instruments	3	51	**Global Software**/computer software	24	–2	undisclosed
Home Shopping Network/retailing	5⅛	1,079	**Precision Software**/voice response systems	NA	NA	early 1992
National Intergroup/wholesale drugs	14	2,879	**Ben Franklin Stores**/discount stores	339	NA	undecided
Team/industrial services	7⅝	103	**Universal Services**/infrastructure maintenance	63	10	undecided
Union Carbide/chemicals	23⅛	7,600	industrial gases[3]	2,400	NA	early 1992

[1]Latest fiscal year. [2]Earnings before interest and taxes. [3]Name of spinoff is yet to be announced. NA: Not available.
Source: Spinoff Report.

These companies plan to spin off subsidiaries to their shareholders. In the past, spinoff stocks as a group have outperformed their former parents. But now that The Street is wise to this historical phenomenon, it's likely that spinoffs won't be available at such bargain prices.

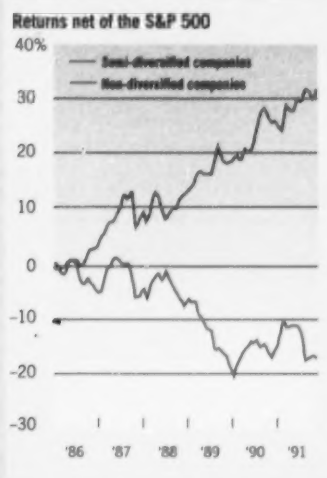
BY ERIC S. HARDY

"This bull market is a result of low interest rates that may be headed even lower, but [it] will need the substance of higher earnings for the rally to be maintained," says market strategist Alan Ackerman of Reich & Co. Ackerman says investors are flocking to the stock market not because equities are good values but because there is such a big penalty (in the form of low yields) to staying in cash. With a flat economy, he is turning cautious. He thinks it's too early, for example, to buy cyclical stocks like chemicals and metals. About the only companies that Ackerman favors are in the food processing and health care industries.

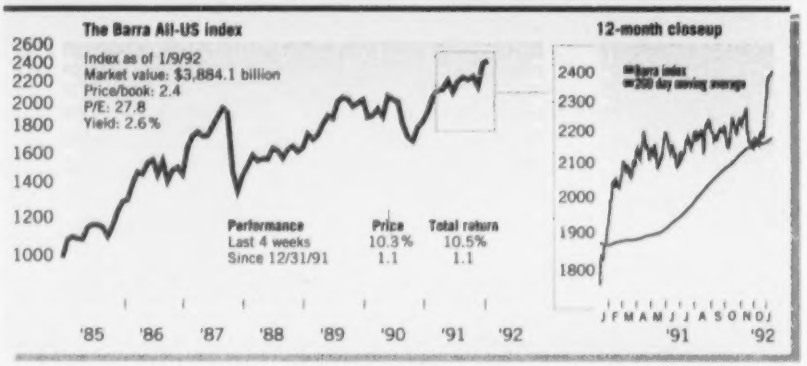
The so-called January effect—when small-company stocks outperform blue chips—worked magnificently in the early days of 1992. Less than halfway through January the Nasdaq is holding an 11% gain for the year, while the broad-based Barra All-US index is up 4%.

Special focus

A little bit of diversification is a good thing. Over the past five years stocks of modestly diversified companies have beaten the market. In contrast, widely diversified conglomerates merely matched the S&P 500 over that period. And despite their recent rally, single-industry stocks underperformed the S&P.



The overall market



Closeup on the market

Index or investment	2-week change	% change from 1 year	% change from 5-year high
Barra All-US index	4.4%	37.1%	0.0%
Sharpe/Barra Growth index[1]	3.4	45.5	-0.1
Sharpe/Barra Value index[2]	3.1	28.0	-0.5
Dow Jones industrials	4.1	28.4	0.0
S&P 500	3.2	32.8	-0.4
NYSE	3.4	33.5	-0.1
Nasdaq	10.8	71.3	0.0
Amex	8.0	36.3	0.0
EAFE[3]	2.9	12.8	-17.7
CRB index[4,5]	-0.3	-5.4	-23.4
Gold[5]	0.6	-8.5	-28.9
Yen[5]	-0.5	-6.3	-23.3
Oil[5]	-3.5	-35.6	-56.6

The best and worst performing stocks[6]

Best	Price	2-week change	1992 EPS[7]	Worst	Price	2-week change	1992 EPS[7]
Liposome	26 ½	102%	$-0.39	Harken Energy	3⅞	-39%	NA
Alkermes	28 ⅜	86	-1.10	Adia Services	15⅛	-17	$1.23
Neva Pharmaceutical	9 ¾	81	-0.25	TJ International	18¾	-16	1.42
Immunomedics	15 ⅞	72	-0.10	Rowan Cos	4¾	-16	0.02
Best Buy	23 ⅞	65	1.56	Transco Energy	16⅝	-15	1.38

The best and worst performing industry factors[8]

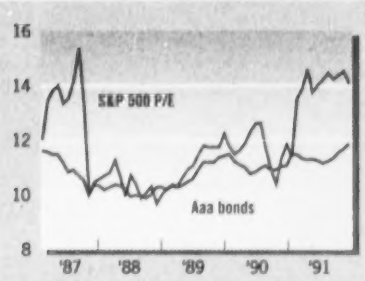
Best	2-week change	Since 12/31/91	Worst	2-week change	Since 12/31/91
Hotels, restaurants	12.3%	11.0%	Oil service	-12.5%	-12.9%
Motor vehicles	11.0	9.4	Aluminum	-0.9	-4.6
Precious metals	10.7	1.7	Thrifts	-0.4	-3.1
Media	10.5	4.7	Gas utilities	0.3	-3.0
Tobacco	10.3	4.0	Leisure, luxury	0.0	-4.8

Note: Data for period ending 1/9/92. The Barra All-US index consists of all publicly traded common stocks for which price quotations are available and ordinary shares of foreign stocks trading on U.S. markets. ADRs, REITs and closed-end funds are excluded. [1] Total return of a portfolio of more than 150 large-capitalization stocks that has high historical earnings growth and has predicted above average earnings growth. [2] Total return of more than 300 large-capitalization stocks characterized by low price-to-book ratios, high yields and low price-to-earnings ratios. [3] A dollar-denominated capitalization-weighted index of more than 1,000 stocks from Europe, Australia, New Zealand and the Far East. Source: Morgan Stanley Capital International Perspective. [4] Index of 21 commodity futures. [5] Knight-Ridder Financial Information. [6] During the last two weeks. [7] Estimate. Source: Institutional Brokers Estimate System, from IBES, Inc. [8] Shows return to the industry factor after controlling for other influences including company size, value and growth characteristics. Multi-industry firms have proportional contributions in two or more groups. NA: Not available. Principal source: Barra, Inc., Berkeley, Calif.

WHAT THE ANALYSTS THINK

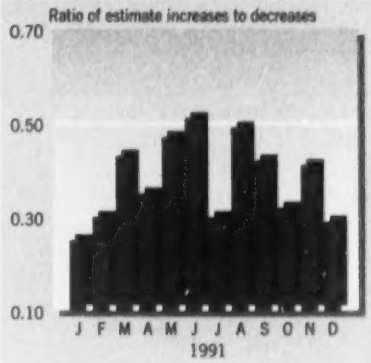
BY STEVEN RAMOS

S&P 500 P/E* vs. Aaa bonds†



*S&P 500 P/E is the recent price of the S&P 500 divided by estimated earnings over the next 12 months. †Actual and projected price-to-coupon ratio for Moody's Aaa corporate bond index.

S&P 500 companies



Forecasting the S&P 500

Year	Estimated P/E	% change current vs. 3 months ago	Expected year-to-year EPS growth
1990[1]	17.5	NA	-7%
1991	19.8	-5%	-11
1992	15.2	-5	30

1991 estimates for industry groups

Rising estimates	Falling estimates
auto parts (replacement)	automobiles
toys	airlines
containers/paper	aluminum
housewares	steel
railroads	misc metals

With the market rallying to record highs, it is not surprising that security analysts—many of whom are biased toward optimism because it's good for their brokerage house employers' business—are putting out optimistic earnings forecasts. Current projections call for an eye-popping 30% increase in profits for the companies underlying the S&P 500 index in 1992 (to $27.40).

Take that optimism with a grain of salt, however. One year ago the same group of Wall Streeters thought that S&P 500 earnings would rise 14% in 1991. It now appears that 1991 earnings will come in 11% *lower* than 1990 earnings.

Here's another reason to be cautious. Even if the 30% earnings gain arrives on schedule, today's stock prices are levitating at 15 times those anticipated earnings. In the past month the price-to-expected-earnings ratio has gone from an 18% premium to a 28% premium over the corresponding ratio for bonds—that is, the price/coupon ratio. The last time there was such a wide discrepancy between anticipated P/Es on stocks and price/coupons on bonds was just before the crash of 1987.

Who's hot

Greatest increase in estimates over the past three months

Company/industry	1991 EPS[2]	1992 estimate: recent	1992 estimate: 3-month change	P/E	3-month price change	Reason
Michigan Natl/banking	$3.02	$4.02	25%	10	8%	Improved lending margins
Goodyear Tire & Rubber/rubber	1.21	3.21	24	17	20	Lower raw material costs, efficiencies from restructuring
Adv Micro Devices/semiconductors	0.70	1.30	23	14	54	Higher revenues from its 386-clone microprocessor
Great Lakes Chemical/chemicals	4.83	6.24	18	18	17	Benefits from acquisition of Octel
Metropolitan Finl/savings & loan	4.54	3.60	16	6	-3	Improved lending margins, strong loan production

Who's not

Greatest decrease in estimates over the past three months

Company/industry	1991 EPS[2]	1992 estimate: recent	1992 estimate: 3-month change	P/E	3-month price change	Reason
Ford Motor/auto	$-4.28	$0.63	-69%	45	-4%	Eroding market share, higher marketing costs
Trinova/machinery	-0.54	0.98	-48	20	-10	Weak European industrial and domestic auto markets
Bethlehem Steel/steel	-2.52	0.86	-47	16	-11	Falling steel prices, decline in sales
Bowater/forest products	1.22	1.02	-39	21	-4	Soft prices for pulp and newsprint
Inco Ltd/metals	1.00	1.44	-37	21	-7	Lower nickel prices, increased production costs

Note: Companies listed have a market capitalization of $100 million or more. [1]Actual. [2]Estimate. Earnings projections are Wall Street consensus estimates data from 3,000 security analysts compiled by the Institutional Brokers Estimate System, a service of IBES, Inc. Aaa bond yield forecasts supplied by Blue Chip Economic Advisors. NA: Not available.

With their funds back in public favor, junk bond fund managers have a problem: Where will they get the merchandise they need?

Empty shelves

WITH THEIR impeccably bad timing, investors, having dumped junk bond funds at low prices in 1990, are now clambering back in. They were attracted not only by high yields but by the news that the junk funds as a group showed total returns of an astounding 36% last year. Through November, customers put $2 billion more into junk bond funds than they took out in withdrawals and monthly dividend checks. That was after they pulled $5 billion net from the same funds in 1990.

Not that junk bond funds do not still offer good yields; they do. But all the new money pouring in poses a huge problem for the fund managers: how to invest it. The managers are competing not only with one another but with bond issuers themselves. The latter are taking advantage of willing equity markets and lower interest rates to replace their high-coupon debt with equity or new, lower-coupon debt. The result is a high-yield bond shortage, predominantly in the top tier, and sinking yields.

RJR Nabisco, Owens-Illinois, Ann Taylor, Duracell, Amphenol and Filene's Basement are just some of the better-quality junk bond issuers that retired some of their bonds in 1991. Mark Vaselkiv, comanager of the T. Rowe Price High Yield Fund, says $87 million worth of the bonds in his $1 billion fund were called or tendered for in the fourth quarter of 1991. He figures that another $180 million are callable by June 1992. He will have trouble reinvesting the proceeds at attractive rates.

Most high-yield bonds were issued between 1986 and 1989 and were noncallable in the first three to five years. Now issuers can refinance them. "The majority of the market is callable in the next two years," says Joseph Bencivenga, director of junk bond research at Salomon Brothers.

During the past year Michael McNamara, manager of Kemper's high-yield portfolios, has been trying to improve his call protection. For example, he traded Lear Siegler Seating 14¼s for another Lear Siegler issue with just a 14% coupon but with two more years of call protection. "I suspect other fund managers are doing the same," says McNamara.

As the managers crowd into the high-yield market, they have to compete with issuers anxious to buy their own debt, sometimes at a discount, and retire it or replace it with lower-yielding debt. Take the case of textile manufacturer Burlington Industries, the object of a 1987 leveraged buyout. Last fall the company used a $70 million bank loan and cash to buy back $250 million face value of bonds on the open market for $133 million. That was after picking up $40 million in face value in a tender offer at 18 cents on the dollar.

Increased demand for junk and the attractiveness of refinancing mean that bonds issued by the higher-grade junk issuers have become scarce. So in order to keep fully invested and maintain an attractive yield, some funds have moved into lower-quality stuff. Here they have found no shortage of bonds because the junk market on the whole hasn't shrunk significantly. Salomon Brothers estimates that the market contracted slightly from $214 billion at the end of 1990 to $203 billion at the end of 1991. The net loss came from repurchases and upgrades of junk debt to investment-grade status. Meanwhile, there have been significant downgrades, holding the supply steady. Case in point: the $30 billion of debt issued by Chrysler Corp. and its finance subsidiary. However, the downgrades usually go to the middle or bottom tier of the junk bond market. "They don't help the situation in the top tier, where demand exceeds supply," says Salomon's Bencivenga.

As investors crowd into this limited segment of the market, prices will continue to rise and yields drop. Take the BB-rated Owens-Illinois 11s. The bonds are callable in 1999 at 103 and are now trading at 106 for a yield to worst of just 10%. (Yield to worst measures the compound annual return that the holder would have, buying at today's price and surrendering in a call that occurred at the most inopportune time.) At 10% those bonds yield just 2.5 percentage points more than top-rated corporates.

Thus the Federated High Yield Trust, which was yielding 17.5% a year ago, now has an 11.7% yield. And the average bond price in its portfolio is now 102, meaning that many of the

Join the crowd

Fund	3-year return[1]	Yield[2]	Manager	Expense ratio[3]
Federated High Yield Trust	9.6%	12.1%	Mark Durbiano	0.78
Fidelity Capital & Income Fund	6.5	10.0	David Breazzano Dan Harmetz	0.81[4]
T Rowe Price High Yield Fund	4.8	11.3	Richard Swingle Mark Vaselkiv	1.03
Vanguard Fixed Income-High Yield	7.5	11.0	Earl McEvoy	0.40
American High Income Trust	11.8	10.3	Multiple managers	1.00
Kemper Diversified Income Fund	12.6	12.6	Michael McNamara	1.23
Liberty High Income Bond Fund	11.6	11.8	Mark Durbiano	1.03
Merrill Lynch—High Income-A	11.6	12.4	Vincent Lathbury	0.66

[1] Annualized. [2] Last 12 months' income dividends, divided by net asset value. [3] Annual expenses as percent of net assets, latest fiscal year. [4] Distributor may impose redemption fee, which proceeds revert to the fund.

Junk yields are still fairly high, but nothing like the bonanzas they were a year ago. The table lists the four largest no-loads and the four best performing out of a group of load funds. Stick to the no-loads unless you need hand-holding from a broker.

bonds are vulnerable to call.

With bond prices so high and new money coming in every day, it is no surprise that some high-yield fund managers have begun trading down in quality. Alan Petersen, manager of the Cigna High Yield Fund, has bought the junk issues of cyclical companies such as Uniroyal Chemical and Quantum Chemical. Vaselkiv of T. Rowe Price is considering adding dollar-denominated Mexican debt, currently yielding 11%, to the T. Rowe Price High Yield Fund.

The shortage of high-quality merchandise explains why one high-yield manager has looked so eagerly at bank debt. Commercial banks are loaded with so-called HLT loans—the debt of highly leveraged transactions. Regulators have been leaning on banks to cut back on HLT loans in their portfolios. By selling off some of these loans the banks can make the regulators happy even if it means parting with some excellent yields.

"The real opportunity was bank debt," says David Breazzano, comanager of Fidelity's Capital & Income Fund, whose charter now permits it to buy defaulted debt as well as solvent junk. "We bought senior, secured bank paper at discounts to subordinated, unsecured junk bonds. We are buying at 50 cents and 60 cents on the dollar." The discount is partially offset by the lower interest rate on bank debt, but Breazzano expects 20% to 30% annual returns on the bank loans. Insurance companies are also selling privately placed lower-rated debt that they hold. "That is a potential opportunity," says Breazzano.

Since FORBES advised investors to buy junk bond funds in its Apr. 30, 1990 issue, the funds have had a 27% total return on average. What now? Don't expect a repeat of 1991. "My portfolio is at $102 [value per $100 of bond par value]," says Mark Durbiano, manager of Federated High Yield Trust. "Could it go to $105? Sure. To $140? Not really."

For yield plus a chance at modest appreciation, the high-yield funds are still attractive. But bear this in mind: A junk bond acts like a cross between a bond and a stock. If the stock market turns sharply down, it could take junk bonds with it, even if interest rates don't go up. –S.O. ■

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